# SUBPRIME SUBMERGED!

The ***subprime mortgage meltdown*** froze the credit markets, panicked nervous investors and submerged the stock market, prompting Bernanke's Fed to cut the rates by a full ½% point which buoyed the stock market back to the surface but sunk the US dollar like a lead balloon.

Well if you hadn't been watching too closely, you may have missed all the drama this story holds. You'd wonder, *"what's all the hubbub about?"* because the 3rd quarter stock and bond returns suggest smooth sailing. But this quarter's benign asset returns masked the turbulence beneath the smooth surface. A tempest in a teapot! The *"subprime summer"* story unfolds...

Time magazine, in *"Cracks in the Economy",* begins this story back in 1997 with the housing boom. For the 100 years prior to 1997 home prices, adjusted for inflation, had not changed much. Then just in the last 10 years, average housing prices doubled. The relentless boom in cities like Miami and Las Vegas triggered greed and speculation pushing prices well beyond risk-averse rationality.

Time notes that the housing boom *"accounted for 46% of new jobs created in the US between January 2001 and May 2006, when the [housing] sector peaked."* At the same time, Alan Greenspan, in trying to keep the economy afloat after the tech-bubble burst, cut short-term interest rates to historically low levels.

The real estate boom added some ballast to our economic ship during this difficult time while the low interest rates allowed us to exploit new found value in our homes at very low costs so we could spend our way out of the 2001 recession keeping it brief and shallow. Now, many blame Greenspan's low interest rates for the housing bubble and the fallout from the bust.

Our *"subprime summer"* story gets somewhat complicated from here, but... Didn't everyone know that the home prices became excessive? Didn't everyone know that the easy money was only temporary? Didn't everyone know that lending practices had become a little fishy?

Yes. And during the beginning of this quarter the strain on the mortgage lenders here at home was evident. Yet no one was prepared for the tsunami this caused in the global credit market whose cash flow is the circulatory system of the entire international economy. On Thursday August 16th, the global credit markets froze.

Commercial paper is the lifeblood of the global credit market. It is a money market security issued by large banks and corporations to manage working capital. Commercial paper is considered a very safe investment, but on the morning of Thursday August 16th in London before our markets opened, these institutional investors, afraid of mortgage defaults, refused to roll over asset-backed commercial paper, accounting for about one-half of the $1.98 trillion commercial paper market.

The tsunami was global. German banks were especially vulnerable because they borrowed heavily in the short-term commercial paper market to invest in longer-term securities, including assets backed by U.S. mortgages. Here at home at 7:30 a.m. Countrywide Financial Corp., America's #1 Home Loan Lender, tapped its $11.5 billion credit line because it was unable to secure money in the commercial paper credit markets.

That Thursday stocks sold off furiously with the Dow Jones Industrial Average under water over 343 points before bouncing off the bottom to stage another rapid assent closing down only 15.69 points. All major indexes tested a **correction** during that day, off more than 10% from a peak. Investors felt seasick.

The depths of the subprime mortgage meltdown are still, as yet, unknown. ***Subprime mortgages are made at higher interest rates to borrowers who have poor credit histories.*** Many banks hold these loans in off balance-sheet affiliates called "conduits". Also youthful financial engineers package these mortgages into Collateralized Mortgage Obligations (CMOs) and then slice and dice them into separate credit tranches with various degrees of risk. These speculative, derivative securities were peddled to the public.


The mortgage brokers were the sharks. The financial engineers exploited the low interest rates fishing the calm financial seas for high ratings. The rating firms steered our ship into unknown perilous waters. Wall Street Journal reports, the rating firms doled out *"...top ratings to many securities built on questionable loans, making the securities seem as safe as a Treasury bond."* A subprime subterfuge!

Would Bernanke, the Federal Reserve Chairman, cut rates before the regular meeting on September 18th? The pundits warned of the **moral hazard** of a rate cut protecting investors against losses, leading them to take greater future risks and suffer greater losses. Bernanke, treading water, employed a rarely used tactic. He lowered rates charged from the discount window which is usually only used by troubled banks, saying *"downside risks to growth have increased appreciably."*

Fed governors called some large, strong banks to assure them that credit would be easily available from the discount window and encouraged them to loan money more freely. Although usually a sign of weakness, the banks agreed and in a sign of solidarity borrowed from the discount window. The Fed's first step, along with the European Central Bank injecting huge amounts of cash into their banking system, calmed the stormy seas of the global credit bond markets for now.

This gave the Fed some breathing room until the regular meeting on September 18th at which the Fed again surprised the experts by aggressively cutting the discount rate by ½% , rather than the anticipated ¼%. The minutes read, *"...the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally."* The stock market rejoiced with the DOW rising over 335 points, or 2.51%, its biggest percentage gain since 2003.

Federal Reserve Chairman Ben S. Bernanke aggressively lowered interest rates a full ½% to stop the subprime credit crunch and deteriorating housing slump from spilling over and sinking the nation's economy. Look for some rough seas ahead in both the credit and housing markets, the unknown depths of which have yet to be tested.

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